



## Mapping Your Way through Due Diligence Requirements for the FHA Loan Program

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Despite the unstable lending market, the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) program has been reliable in providing the most loans with the lowest rates in the market. Today, in both affordable and market rate housing, HUD remains sustainable and accountable, and has only made modest changes in underwriting as a hedge against a volatile market place. As of today, HUD is the affordable source for borrowers and developers and is as busy as ever.

For those seeking HUD financing under its Multifamily Accelerated Process (MAP) program, environmental and engineering due diligence requirements are substantially different from those required by Government-Sponsored Enterprises (GSE) such as Fannie Mae and Freddie Mac.

### Delegated vs. Non-Delegated Underwriting

Fannie Mae utilizes what is called delegated underwriting, whereby the agency creating the underwriting guidelines delegates the responsibility to the lenders. The GSE lender in this case is the final authority for underwriting guidance. With HUD, the lenders provide underwriting tasks then submit the entire loan package to the regional HUD office for review. The third-party reports along with the entire loan package are then reviewed by HUD which acts as the final authority in the acceptance of the loan to be insured.

But what makes HUD due diligence unique, is that it has its own set of guidelines for the Property Capital Needs Assessment (PCNA) and the Phase I Environmental Site Assessment (ESA),

### HUD Project Capital Needs Assessments

There are some distinctions that clearly define a FHA/HUD Physical Inspection Report (PIR – a part of the PCNA). Most notable are the glaring differences in the capital replacement reserve analysis requirements. Not only does a FHA/HUD loan typically require a 37-year loan term (as opposed to

the standard 10+2 or 20-year loan term for Fannie Mae or Freddie Mac), but also a higher Initial Deposit and Annual Deposits for reserves with a “healthy” remaining balance. The additional years also mean that more realty items, such as windows, cabinetry, etc. that would not typically require replacement within the 12- or 20-year loan term scenarios, will need to be budgeted for replacement, adding to the overall capital reserves. Ultimately, these requirements can create a tricky situation for the lenders in their underwriting process.

Other key distinctions of a HUD PCNA include:

- Tables:
  1. Critical and Non-Critical repairs. Comparable to Immediate Repairs, but HUD distinguishes between life safety and non-life safety repairs.
  2. Capital Replacement Reserves. Much longer term ( 37 or 42 years).
    - Accessibility issues are always critical repairs
    - Accessibility reviews must encompass FHA, ADA & UFAS. Consultants need to understand each of them, when they apply and know the differences between them.
    - Smoke Detectors must be inside all bedrooms, outside every sleeping area in the immediate vicinity of the bedrooms, and on all levels of the dwelling unit, including basements. If they’re not, they must be added to the critical repairs.
    - Sub-rehab analysis. If a property has a lot of needed repairs, sub-rehab may be required. HUD Forms. Your consultant must learn to love them. Not all of the sections are intuitive but the form instructions are helpful.
    - Net rentable square feet (square feet) vs Gross square feet. HUD considers net rentable square feet as paint-to-paint, which is typically less than the values provided by the leasing office via the rent rolls or marketing brochures.

### **HUD Phase I Environmental Site Assessments**

The HUD Environmental Site Assessment is just as unique as the PCNA, with an emphasis on policy and procedure. If a mortgagor defaults on the FHA-insured project, HUD could possibly become the owner. Under Section 120 (h) of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), and stated in the HUD guidelines: Federal agencies that own properties are required to make “all remediation necessary to protect human health and the environment” with respect to known hazardous substances upon disposition of the property.

Therefore, HUD’s goal is to limit their liability as well as ensure the health and safety of their portfolio.

The Phase I ESA report must meet strict requirements of the American Society of Testing Materials (ASTM) Standards. For example, for buildings constructed prior to 1978, comprehensive asbestos and lead-paint surveys and/or Operations & Maintenance (O&M) plans are required. While HUD does not require Radon testing as part of the environmental assessment, the radon zone in which the site is located must be noted in the Phase I ESA report. Additionally, if radon remediation systems currently exist or have existed at the site in the past, the environmental professional should determine if radon sampling is warranted.

In conjunction with (and incorporated within) the Phase I ESA, a special HUD form, called the “Environmental Assessment and Compliance Finds for the Related Laws” (Form 4128) must be completed. Although HUD personnel are technically responsible for completing this form, which address issues beyond the scope of the ASTM standards, third-party vendors typically complete this form as part of the Phase I report in order to provide HUD personnel with a brief overview of any

environmental concerns that may be associated with a particular project. As such, third party vendors should not sign this completed form.

The HUD Form 4128 includes a noise analysis for the project as well as coordination with the State Historic Preservation Office and the U.S. Fish & Wildlife Service to insure the project will not affect historic properties or endangered species, respectively. Although these three items are designed more for new construction as opposed to existing projects, HUD Offices require the third-party vendor to complete these sections for all projects in order to determine if any issues exist that may require correction.

HUD has already begun requiring a Tier I Vapor intrusion (VI) screen as defined by ASTM with the Phase I Environmental Site Assessment. Per the Tier I guidelines, an environmental professional must perform an initial vapor intrusion screen to determine if there is a potential for toxic vapors to exist onsite as a result of an onsite or offsite release.

The full menu of HUD form 4128 items to review includes:

- Hazardous Operations
- Toxic Chemicals & Radioactive Materials
- Historic Preservation
- Flood Plain Management
- Wetlands Protection
- Endangered Species
- Noise Analysis
- Explosive / Flammable Hazards
- Coastal Barrier Resources
- Coastal Zone Management
- Farmland Protection
- Sole Source Aquifers
- Underground and/or Aboveground storage tanks
- Airport Hazards (Clear Zones, Accident Potential Zones, etc.)
- Other Federal State Laws
- Environmental Justice
- Unique Natural Features and Areas
- Site Suitability
- Soil stability, erosion, and drainage
- Water supply, sanitary sewers, and solid waste disposal
- Schools, parks, recreation, and social services
- Emergency Health Care, Fire, and Police services
- Commercial / retail and transportation
- Local zoning compliance
- Additional Hazards and Nuisances (electrical tower fall zones, natural gas and other pipelines, etc.)
- Acceptable Separation Distance evaluations
- Tier I Vapor Intrusion (VI) screening
- Unresolved conflicts concerning use of the project site

The in-depth review and scrutiny offered by each HUD local office that reviews the third party reports is what matters. HUD will insure these properties for 37 years and expects to ensure the health and safety of its constituents over this time frame.

### **Project Timelines**

The timeline of HUD projects can be a bit tricky due to the level of oversight and review. The clock starts ticking on the date of the on-site inspection, which should always be used as the date of the report. A HUD PCNA has a shelf life of 120 days and the HUD Phase I ESA report enjoys a little longer life of 180 days. If the lender fails to submit the report to HUD prior to the expiration date, the lender will have to hire the third party to re-inspect the property.

Third-party reports must be submitted to HUD as part of the underwriter's package, within the times listed above, taking into account the additional time needed for multiple drafts for the third-party reports prior to submitting the finals.

#### *-Save time for revisions*

For PCNAs there is always at least one round of corrections, adjustments etc., to the initial draft submitted for review. Borrowers also frequently request changes to the PCNA repairs or reserves after reviewing estimates. They may also include "owner elective repairs," which must always be included in the list of non-critical repairs in the PCNA.

#### *-Time consuming items*

In addition, there are some processes that can eat up a large chunk of time. For example, the form HUD-92329 (Property Insurance Schedule) requires the due diligence consultant to use the appraiser's values to calculate the insurable value of the buildings. However, the appraiser needs the PCNA, particularly the repairs and reserves, to complete its appraisal, which in turn is needed to complete the HUD 92329 form. Confusing, yes. Time consuming, indeed. . After the loan package is submitted to HUD, HUD has a certain period of time to review and underwrite the loan. During HUD's review, they may come up with questions or concerns about the reports. When this happens, the HUD office will write a "deficiency letter" and send it to the lender. These become fire drills for the third party, because the lender usually only has a couple of days to respond to HUD, or else the whole deal is put on hold.

All-in-all, the third party should expect to be working on the same file for three months and occasionally, up to a year.

### **Policy Changes on the Horizon for HUD**

As HUD seeks efficiency and consolidation within HUD PCNA and ESA due diligence guidance, there are a few changes that we may see in the future for multifamily guidance that may impact third-party markets.

- Rumor of a revised HUD Map guide within the next year.
- Clarifying the technical scope and content of a HUD PCNA report; to include a Green PCNA which will be defined as a "Light Green" Scope of work which is expected to be released in late summer 2011.
- 20-year forward reserve for replacement deposit funding from a 37 year term.
- Establish a minimum reserve for replacement account balance proposed at 10 percent of 20 year capital needs or 2 years annual deposits, whichever is higher.
- Stronger guidance concerning Fair Housing Act accessibility items with the use of the reserve for replacements to correct the violations in the near term.

As HUD MAP remains consistent with its historic role as a provider of counter-cyclical lending and accountability, HUD also remains consistent with policy change to reflect the economic conditions to sustain its mission.

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